In the Matter of:

U.S. DEPARTMENT OF LABOR
PENSION AND WELFARE BENEFITS
ADMINISTRATION,
Complainant

v.

RICHARD L. SMITH and SMITH
ADMINISTRATORS,
Respondents

Date Issued: January 20, 1998

OALJ Case No: 91-RIS-1
PWBA Case No.: 71-06591

Appearances:
Stevan Durovic, Office of the Solicitor, U.S. Dept. of Labor, for Complainant

Wesley Argyle, Black, Stith & Argyle, for Respondent

Before: James Guill, Associate Chief Judge

DECISION AND ORDER

This case arises under the Employee Retirement Income Security Act of 1974 ("ERISA" or the "Act"), 29 U.S.C. § 1106 *et seq*., and the regulations promulgated thereunder at 29 C.F.R. Part 2560 *et seq*.

I. Statement of the Case

The Smith Administrators Medical Fund (the "Fund" or "Plan") was established by Smith Administrators and Richard L. Smith ("SA" or "Respondents"), to provide health and welfare benefits for participating employees of its clients. As administrators, Respondents provided administrative, claims processing, and management services to a number of private employee welfare benefit plans covered by ERISA.

As the independent employee benefits administrator for approximately 300 clients, SA was responsible for administering health and welfare plans for over 35,000 participants. SA had been a going concern since approximately 1976 and, as of the middle of 1990, employed around 120 people. From 1985 until 1989, Richard L. Smith, Chief Executive Officer and sole shareholder of SA, engaged in over fifteen transactions involving amounts of up to $700,000.00; most of the funds he used in these transactions were transferred out of the trust fund SA maintained for its clients.

The U.S. Department of Labor, Pension and Welfare Benefits Administration ("PWBA" or

"Complainants") conducted an investigation and alleged that Respondents engaged in transactions that involved the transfer of Plan assets to Respondents, a party-in-interest, as defined in sections 3(14)(A) and (B) of ERISA, to the Plan. Such transactions are prohibited under section 406(a)(1)(D) because of the inherent conflicts of interest involved therein. Complainants assessed a civil penalty against Respondents in the amount of $247,168.00 pursuant to section 502(i) of ERISA and the regulations promulgated thereunder. In its answer, Respondents challenged the assessment of the penalties on various factual and legal grounds as discussed below.

II. Procedural History

The Regional Administrator issued a *Notice of Assessment* on April 1, 1991, assessing a total of $247,168.00 in civil penalties against Respondents, for violations under sections 406 and 502 of the Act. Respondents subsequently requested a hearing whereupon the case was referred to this Office.

After a relatively lengthy delay which was largely the result of Respondent's dilatory compliance with several of my preliminary discovery orders, on January 10, 1994, this Office issued *Prehearing Order Number One*, advising the parties of a detailed discovery schedule to be completed by July 22, 1994, and that a hearing was scheduled in Salt Lake City, Utah on August 29, 1994. Specifically, the following documentation was requested: 1) a prehearing statement of the factual and legal issues in dispute with a specific statement of each party's respective position and legal grounds therefore; 2) a list of witnesses and a brief statement of each witnesses' expected testimony; 3) submission of any expert witness testimony in written form; 4) the party's paginated and clearly identified proposed exhibits; and 5) submission of a joint stipulation of facts. With regard to the exchange of proposed exhibits, the *Order* specifically provided that "[a]bsent compelling reasons, failure to so exchange a proposed exhibit will be grounds for refusal to admit it at the hearing."

On August 17, 1994, Complainant filed a *Motion to Postpone Hearing Date* and discovery schedule, noting that the parties had not complied with the discovery schedule, partially because Respondent Richard L. Smith was no longer represented by counsel. Complainant requested that the hearing be postponed for 60 days, stating that "[t]he parties are very actively engaged in attempting a resolution and settlement of this complicated matter."

This Office issued an *Order Rescheduling Hearing and Requesting Interim Reports* on August 19, 1994. The parties were advised that 1) all prehearing filings required in the *Prehearing Order Number One* were due on September 30, 1994, 2) the hearing would be rescheduled for the week of October 31, 1994, and 3) interim reports were to be filed with this Office every two weeks detailing the status of the settlement negotiations.

Complainant complied with all applicable orders. However, Respondent failed to respond to the *Prehearing Order*. In an *Order* dated January 3, 1995, this Office noted that

> [c]onsidering that (1) counsel subsequently withdrew from this case, (2) Respondent Smith Administrators is no longer in existence, (3) nine months of time had elapsed between prehearing orders, and (4) a hearing was specifically set for this case under

the January 1994 Prehearing Order, it was essential that Respondents comply with the Order. They did not.

Accordingly, Respondents were barred from entering documentary evidence or testimony in support of their defenses to the alleged violations and were denied an oral hearing. Both parties were ordered to adopt the *Statement of Undisputed Facts* filed by Complainant on September 30, 1994. Respondents' evidence was therefore limited to Complainant's *Statement of Undisputed Facts*, which included Respondents' answers to interrogatories and requests for admissions; an affidavit of John Olcese, the Department of Labor's investigator; and Respondents' legal brief wherein Respondent was ordered to provide legal arguments with supportive reasoning regarding the legal ramifications of each of the transactions, including whether the transaction was a "conversion" or a "loan" of Plan[1] assets, and the amount of civil penalties it deemed proper. The Complainant and Respondents submitted their briefs on February 23 and 24, 1995 respectively.

III. Discussion

A. Statutory Framework

In 1974 Congress passed ERISA as a comprehensive federal law covering nearly all employee benefits plans. Congress' intent was to ensure that benefits promised by employers to their employees would in fact be paid. The ERISA provisions are a mix of both labor and tax law.

The labor law provisions govern, *inter alia*, the conduct of the pension and welfare plan fiduciaries by providing fiduciary standards of conduct and prohibiting fiduciaries from engaging in certain transactions with parties-in-interest who have relationships with the plans. Civil money penalties of up to 5% of the amount involved in prohibited transactions may be assessed under the labor provisions of ERISA on fiduciaries who breach their duty to the plan participants and beneficiaries. ERISA § 502; 29 C.F.R. § 2560.502i-1(e)(1).

The tax portion amends the Internal Revenue Code, governing the conduct of "disqualified persons" (similar to parties-in-interest) and empowers the Internal Revenue Service to assess 5% excise taxes on disqualified persons who violate the "prohibited transaction" rules. Notably, the tax provisions apply only to plans that received preferred treatment under the IRC (so-called "qualified plans") while the labor provisions at issue here apply to all other types of employee benefit plans (so-called "nonqualified plans").

The ERISA fiduciary rules apply to "any employee benefit plan if it is established or maintained…by any employer engaged in commerce or in any industry or activity affecting commerce." ERISA § 4(a); 29 U.S.C. § 1003(a). The term "employee benefit plan" includes pension

[1]Sometimes also referred to as the "Fund" or "Trust Fund."

plans and welfare plans.[2]

The fiduciary rules were established to ensure that individuals who control plan assets do so solely in the interest of plan participants and beneficiaries, and for the exclusive purpose of providing benefits to plan participants and beneficiaries. Fiduciaries are personally liable and liable for actions of co-fiduciaries for any loses they cause a plan to experience because of a breach of their duties. *See* ERISA §§ 405(a) & 409(a).

Each plan must have at least one "named fiduciary" who is designated in the plan document as being responsible for controlling and managing the plan's operation and administration. ERISA § 402(a)(2). In addition to the named fiduciary, an individual who performs certain plan management functions is treated as a plan fiduciary. *See* 29 C.F.R. § 2510.3-21. According to ERISA section 3(21)(a), a person is a fiduciary with respect to a plan

> to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. § 1002(21)(A)

Persons who merely perform ministerial or administrative functions but who have no power to make decisions on plan policy, interpretations, practices or procedures, are not plan fiduciaries.[3] Individuals or companies that provide services to plans are usually not plan fiduciaries as long as they stay within professional boundaries. Examples of such services providers are lawyers, accountants, actuaries and third party administrators.

The fiduciary duties set forth in ERISA section 404(a)(1) provide that:

> [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the

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[2]Pension plans provide retirement income or defer income until the employee terminates employment. ERISA § 3(2). Welfare plans provide medical benefits, death or unemployment benefits, and other non retirement benefits including vacation, scholarship, training and child care benefits. ERISA § 3(1).

[3]According to ERISA Interpretive Bulletin 75-5, these functions would include: Application of rules determining eligibility for participation or benefits; Calculation of services and compensation credits for benefits; Preparation of employee communications material; Preparation of reports required by government agencies; Calculation of benefits; Orientation of new participants and advising participants of their rights and options under the plan, Collection of contributions and application of contributions as provided in the plan; Preparation of reports concerning participants' benefits; Processing of claims; and Making recommendations to others for decisions with respect to plan administration.

participants and beneficiaries and-

> (A) for the exclusive purpose of:
>
> > (i) providing benefits to participants and their beneficiaries; and
> >
> > (ii) defraying reasonable expenses of administering the plan;
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> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
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> * * *
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV.

When discharging these duties, the fiduciary must act solely in the interest of participants and beneficiaries. This requirement has been held to require fiduciaries to act with complete and undivided loyalty to the participants and beneficiaries.

Section 406 of ERISA specifically prohibits certain transactions known as between plans and "parties-in-interest." Parties-in-interest include, *inter alia*, fiduciaries, plan sponsors, participants and beneficiaries, people who provide services to the plan, and their relatives. ERISA § 3(14). Prohibited transactions include the lending of money or extending of credit and the transfer to or use by or for the benefit of a party in interest of any assets of the plan. ERISA § 406(a). Section 406(b) of ERISA adds further fiduciary prohibitions including self dealing with plan assets, representing interests other than those of participants and beneficiaries, and receiving any consideration from any party dealing with the plan in transactions using plan assets.[4]

The U.S. Department of Labor has taken a very expansive view of section 406, reading it as imposing on fiduciaries the duty of individual loyalty to the plans for which they act:

> When fiduciaries exercise the authority, control or responsibility which makes them plan fiduciaries in transactions in which they have other business or personal interest, or represent parties who have such interest, the fiduciaries have engaged in [prohibited] transactions.

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[4] ERISA § 406(b)(1) states that a fiduciary shall not "deal with the assets of the plan in his own interest or for his own account…." Correspondingly, ERISA § 406(b)(2) requires a fiduciary not to act "in any transaction involving the plan on behalf of a party (or represent a party) whose interest are adverse to the interest of the plan or the interest of it participants or beneficiaries…."

Exemption Application No. D-7257.

Certain statutory exemptions to the prohibited transaction rules exist under ERISA section 408. For example, section 408(b)(2) provides that the prohibited transaction rules do not apply where the transaction involves the

> [c]ontracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.

Similarly, nothing in section 406 is to be construed to prohibit any fiduciary from

> (2) receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan; except that no person so serving who already receives full time pay from an employer or an association of employers, whose employees are participants in the plan, or from an employee organization whose members are participants in such plan shall receive compensation from such plan, except for reimbursement of expenses properly and actually incurred; or
>
> (3) Serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

ERISA §§ 408 (c)(2) & (3), 29 U.S.C. § 1108.

However, there are no section 408 exemptions for section 406(b) self-dealing violations. In fact, section 406 transactions are *per se* prohibited. As pointed out by the court in *Donovan v. Cunningham*, 716 F.2d 1455, 1464-5 (5th Cir. 1983), “[t]he object of section 406 was to make illegal *per se* the types of transactions that experience had shown to entail a high potential for abuse.” Intent is not an element. In order to establish a violation of section 406, the Department of Labor must show that there was a: 1) prohibited transaction, 2) not otherwise exempted, 3) involving plan assets 4) between a covered plan and a party in interest 5) knowingly caused by a fiduciary to the plan.

B. Fiduciary Status of Respondents

The parties have not agreed to any stipulations with respect to facts or exhibits in this case. However, PWBA submitted a *Prehearing Statement* and a *Statement of Undisputed Facts* on September 30, 1996 in which it set forth its version of the facts and its theory of the case. As discussed above, Respondents were barred from submitting any documentary evidence and testimony as a result of their non-compliance with the *Prehearing Order* and were ordered to adopt Complainant’s *Statement of Undisputed Facts*.

In its *Memorandum on Penalties for Prohibited Transactions Pursuant to the Court’s Order of January 3, 1995*, Complainant stated that

> [t]he Court's January 3, 1995, Order had previously found that respondent Richard L. Smith is principal owner of respondent Smith Administrators, Inc. ("SA"), that Smith an SA are or were parties-in-interest and fiduciaries under ERISA with respect to the affected Fund at all times relevant to these proceedings.

Respondents, however, argue that

> [w]hile the Complainant has been granted the right by the Court to limit the facts of the case to those in its 'Statement of Undisputed Facts' it has not been permitted to manipulate the Statement to limit the legal arguments available to respondents.

Respondents noted that there have been no requests for admissions or interrogatories on the issue of fiduciary status and that Complainant has produced no documentation on this point.

Respondents argue that the fact of their fiduciary status with regard to the Fund has not been established. I agree. Complainant's statement of undisputed facts ordered adopted by the parties indicates, in relevant part, that "Respondent Richard L. Smith does not dispute that at all times relevant to this action SA and Smith, himself, were fiduciaries to the plans…." This statement is not equivalent to an admission by Respondents that they were in fact fiduciaries: Respondents apparently were not ever asked whether they regarded themselves as fiduciaries. Accordingly, I must consider legal arguments, based on the facts as adopted by the parties and other evidence in the record on the issue of whether the Respondents were fiduciaries with regard to the Fund.

Generally, individuals or companies that provide services to a plan, such as third party administrators, are usually not plan fiduciaries. They must, however, stay within professional boundaries to avoid fiduciary status. Fiduciaries may be "named fiduciaries" or become fiduciaries by virtue of their function or conduct. This functional status analysis is based on ERISA section 3(21)(a). A person is a fiduciary with respect to a plan *to the extent that* he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets or he has any discretionary authority or discretionary responsibility in the administration of such plan. *See also* 29 C.F.R. 2509.75-5.

According to the *Statement of Undisputed Facts*, which is based on Respondents' answers to interrogatories and requests for admissions, Respondent Smith owned or controlled 100% of the stock of SA and was SA's chief executive officer until approximately October 31, 1989. Smith had oversight of the day to day operations of SA from prior to October 11, 1985 until approximately October 31, 1989. According to the Claims Processing Service Agreements [Exs. C1 & C2], the funds in the Medical Trust account are made up of contributions from the participating employers.

On January 9, 1990, John Olcese, an investigator for PWBA, interviewed Respondent Smith. Mr. Olcese reduced the contents of the interview to a written *Report of Interview* on June 28, 1990. According to the *Report of Interview*, Mr. Smith was the chief executive officer and principal shareholder of SA, and managed the day-to-day operations of SA. Among other third party administrator services, SA invested its clients' funds in money market accounts and other investment vehicles.

SA's fees were based either on a percentage of the premium amount billed to the client or on a per participant basis. Premium amounts were determined by a two and one half month exposure formula. This was an amount set to maintain a balance in each client's account of two and one half month's expenses, including average claim payments, insurance payments and fees due SA. As part of the negotiations, SA usually agreed to pay a certain amount of interest on the two and one half months exposure balance that the client maintained. These excess balances were "invested by SA in money market accounts." Mr. Smith met with the head of the accounting department at SA and the head of the enrollment department approximately twice a month, and he decided how much money would be placed into the money market accounts. Mr. Smith made his decisions on amounts needed to pay claims, insurance premiums and fees due SA as well as interest rates that were due on the client's funds.

The *Report of Interview* also stated that Mr. Smith knew that the assets in the medical fund belonged to his clients, and that he was always aware of his "fiduciary responsibilities" regarding those assets under ERISA. *Report of Interview* at 8. On numerous occasions the *Report* indicates that Mr. Smith knew that it was inappropriate to use the plan assets as collateral for his loans but that he had no other choice to keep the company solvent. *Id.* at 4-8

As part of its trial exhibits, Complainant submitted a Claims Processing Service Agreement, entered into by and between Summit Health, Ltd. and Smith Administrators, wherein Summit Health engaged SA as the "claims processor for the plan and to assist in the administration of the plan." Ex. C1. In paragraph 4 of the agreement, Summit Health agreed to "maintain a Trust Account with SA." In paragraph 5, Summit Health agreed to make payments to Smith Administrators for deposit to the Trust Account. The Smith Administrators Claims Trust Account Operating Guidelines, which went along with the Claims Processing Service Agreement stated in paragraph D that

> [t]he name of the account will be in the name of SA but designated as a "trust account" or as an "agency account" or other designation *which indicates the fiduciary position of SA with regard to the account.*

(emphasis added).

This evidence appears on its face to be probative on the issue of whether Respondents were fiduciaries with respect to the plan. I consider Mr. Smith's statements to the investigator to be admissions by a party opponent. *See* Fed. R. Evid. 801(d)(2). Accordingly, I accept as admissible and probative the statements made by Mr. Smith during the interview with the investigator, to the extent that Mr. Smith's statements are not contradicted by other evidence in the record or are otherwise not inconsistent with other evidence in the record.

I find that Respondents had, as a general matter, fiduciary responsibility with respect to the Fund. Mr. Smith made investment decisions with regard to Plan assets and admitted its fiduciary position with regard to the trust accounts in its Claims Processing Service Agreement. This, however is not enough to determine liability. Because a person is a fiduciary with respect to a plan only "to the extent" that he exercises any discretionary authority or control respecting management or disposition of its assets, I must examine each transaction and make separate determinations as to Respondents' fiduciary status and liability.

C. Alleged Prohibited Transactions

1. Primary Transactions

On October 11, 1985, Respondent SA executed a promissory note in the amount of $196,107.22 in favor of Brighton Bank (hereinafter "Loan No. 25-20129-4") and apparently pledged CD No. 328 as collateral for the note.[5] Ex. C4. CD No. 328 matured on October 11, 1986, and on October 13, 1986, Respondents rolled the net proceeds of CD No. 328 over into CD No. 346, issued by Brighton Bank in the name of "Smith Administrators Medical Claims Account."[6] Ex. C6. On the same day, Respondents renewed Loan No. 25-20129-4 and pledged CD No. 346 as collateral for the loan. Respondents admit that CD No. 346 was purchased with funds from the Medical Trust accounts. *Respondent's Response to Request for Admission No. 11*.

On February 23, 1987, Respondent SA executed a second promissory note in the amount of $171,000.00 in favor of Brighton Bank (hereinafter "Loan No. 25-20148-4") and purchased CD No. 350 in the amount of $171,000.00; CD No. 350 was pledged as collateral for this loan.[7] Exs. C20, C21 & C22. CD No. 350 was issued in the name of "Smith Administrators Medical Claim." Ex. C21.

On July 20, 1987, Respondents executed several transactions. On July 20, SA issued a check to itself from the Medical Trust Fund in the amount of $719,560.56. Ex. C28. Of this amount, SA used $300,000.00 to purchase CD No. 11813-17420 from Tracy Collins Bank (hereinafter "TC") and the

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[5]CD No. 328 was outstanding from October 11, 1985 to October 11, 1986 at an interest rate of 7.625%. CD No. 328 was apparently issued in the name of "Smith Administrators Medical Claims Account." Ex C16.

As I indicated above, there is no independent evidence documenting the existence of CD No. 328 or its status as collateral for Loan No. 25-20129-4 with the exception of Exhibit 16 which is a *Record of Collateral: Ledger Copy*. This exhibit indicates that CD No. 328 was replaced at some point in 1986 by CD No. 346. I infer from this exhibit that CD No. 328 was, in fact, pledged as collateral to secure Loan No. 25-20129-4 until its maturity date of October 11, 1986.

[6]CD No. 346 was a one-year CD which returned 5.125%. Ex. C4.

[7]CD No. 350 was outstanding from February 23, 1987 to August 23, 1987 at an interest rate of 5.625%. Ex. C21.

remaining $419, 560.56 to repay Loan Nos. 25-20129-4 and 25-20148-4.[8] Exs. C29, C30 & C33. Also on July 20, SA executed a promissory note in favor of TC in the amount of $370,000.00 (hereinafter "Loan No. 1310001"), and Respondent Smith individually executed a second promissory note in favor of TC in the amount of $320,000.00 (hereinafter "Smith loan"). Exs. C7 & C31. Apparently, a portion of these loan proceeds were then used to repay $419,560.56 to the Medical Trust Fund, the total amount, including accrued interest, that had previously been borrowed from the Plan. Both CD Nos. 346 and 350 were pledged as collateral for Loan No. 1310001. Ex. C8. Further, CD No. 11813-17420 was pledged as collateral to secure the Smith loan. Ex. C32.

On August 26, 1987, Respondents rolled over the proceeds of CD No. 350, totaling $173,428.64, into CD No. 11813-17493 issued by TC.[9] Ex. C23; *Respondent's Response to Complainant's Interrogatory No. 34* at 10. Thereafter, on October 13, 1987, CD No. 346 matured, and Respondents rolled over its proceeds, including accrued interest, into CD No. 11813-17572 in the amount of $249,683.99 issued by TC; this CD was pledged as collateral on Loan No. 1310001 on October 15, 1987.[10] Ex. C10 & C11. On October 19, 1987, CD No. 11813-17493 matured, and Respondents rolled its proceeds over into CD No. 11813-17579 issued by TC in the amount of $175,096.40; this CD was apparently pledged as collateral for Loan No. 1310001.[11] Ex. C26. Also on October 19, CD No. 11813-17420 matured, and Respondents rolled over its proceeds into CD No. 11813-17578 issued by TC in the amount of $304,861.64.[12] Ex. C36.

On January 1, 1988, CD Nos. 11813-17572, 11813-17579, and 11813-17578 all matured. Respondent rolled over the proceeds of each CD into CD No. 11813-17735 issued by TC in the amount of $700,000.00 which was pledged as collateral for Loan No. 1310001.[13] Ex. C15;

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[8]CD No. 11813-17420 was issued on July 20, 1987 and reached maturity on October 19, 1987; the CD paid 6.50% annual interest. Ex. C30.

Once SA paid off Loan Nos. 25-20129-4 and 25-20148-4, CD Nos. 346 and 350 ceased to be collateralized.

[9]CD No. 11813-17493 was outstanding from August 26, 1987 to October 19, 1987 at an annual interest rate of 6.50%. This CD continued to collateralize Loan No. 1310001. Ex. C23.

[10]CD No. 11813-17572 was outstanding from October 13, 1987 to January 1, 1988 at an annual interest rate of 7.00%. Ex. C10.

[11]CD No. 11813-17579 was outstanding from October 19, 1987 to January 1, 1988 at an annual interest rate of 7.00%. Ex. C26.

[12]CD No. 11813-17578 was outstanding from October 19, 1987 to January 1, 1988 at an annual interest rate of 7.00%. Ex. C36.

[13]Interest that had accrued to January 1, 1988 on these CDS in the amount of $42,663.10 was deposited in the Plan's account on January 20, 1988. Ex. C18.

CD No. 11813-17735 was outstanding from January 1, 1988 to May 18, 1988 at an annual interest rate of 6.65%. Ex.
(continued...)

Respondent's Response to Request for Admissions No. 74 at 19. CD No. 11813-17735 reached maturity on May 17, 1988 at which time it was rolled over into CD No. 11813-17916 issued by TC in the amount of $715,304.13.[14] Ex. C40. CD No. 11813-17916 was apparently pledged as collateral for Loan No. 1310001 as well as for the Smith loan. *Respondent's Response to Request for Admissions No. 83* at 22.

When CD No. 11813-17916 matured on September 14, 1988, it was rolled over into CD No. 11813-18225 issued by TC in the amount of $715,304.13 and pledged as collateral on both Loan No. 1310001 and the Smith loan.[15] Ex. C47, C49, C50 & C48. On September 15, 1989, CD No. 11813-18225 was redeemed for $770,892.12 and the proceeds were deposited in Plan's account. Ex. C52 & C53.

2. Secondary Transactions

a. Respondent's Use of $100,000.00

On December 9, 1988, SA used $100,000.00 from the Plan's premium transfer account to purchase a $100,000.00 cashier's check from Zion First National Bank. Ex. C59. Thereafter, on March 14, 1989, Respondent Smith used $83,000.00 of this money to purchase CD No. 19-006717 issued by Capital City Bank (hereinafter "CCB") on behalf of Commemorative Publications, a company wholly-owned by Smith. Ex C60. Respondent Smith then pledged this CD as collateral on an $83,000.00 loan from CCB to Commemorative Publications. Ex. C61.

On March 27, 1989, Respondent Smith deposited his personal check in the amount of $17,000.00 and a check from CCB in the amount of $335.34 into the SA's operations account. Exs. C62 & C63. On that same day, Smith deposited a check from SA in the amount of $17,335.34 into the Plan's deposit account. The remaining $83,000.00 and $2,000.00 of accrued interest was restored to the Plan on October 31, 1989 as a part of the sales agreement between SA and ALTA Health Strategies. Exs. C55, C56 & C57.

b. Respondent's Use of $8,252.27

On June 28, 1989, Respondent SA refunded commissions in the amount of $8,252.27 to Quaker State using a check drawn on the Plan's carrier account. Ex. C66. This amount remained outstanding until it was repaid on October 31, 1989 as a part of the sales agreement between SA and

[13](...continued) C15.

[14]CD No. 11813-17916 was outstanding from May 17, 1988 to September 14, 1988 at an annual interest rate of 6.75%. Ex. C40.

[15]CD No. 11813-18225 was outstanding from September 14, 1988 to September 14, 1989 at an annual interest rate of 7.75%. Ex. C47.

ALTA Health Strategies. Exs. C55, C56 & C57.

c. Respondent's Use of $5,716.38

On October 31, 1989, various bank charges in the amount of $5,716.38 incurred by SA and improperly paid out of the Plan's account were restored to the Plan as a part of the sales agreement between SA and ALTA Health Strategies. Exs. C55 & C56.

C. Penalty Calculations

1. Amounts Involved

The key component in the penalty calculation under 29 C.F.R. § 2560.502i-1(a) is the "amount involved" in the prohibited transaction: the civil penalty imposed on parties-in-interest who engage in prohibited transactions is 5% of the total "amount involved." Section 2560.502i-1(b) indicates that "amount involved" is defined according to the provisions of § 4975(f)(4) of the Internal Revenue Code. This section provides that 26 C.F.R. § 53.4941(e)-1(b) is controlling as to the interpretation of "amounts involved."

Section 53.4941(e)-1(b) defines "amount involved" as the greater of the amount of money and the fair market value ("FMV") of the other property given or the amount of money and the FMV of the other property received. Where the use of money or property is at issue, the "amount involved" is the greater of the amount paid for such use or the FMV of such use for the period for which the money or property is used. For purposes of the discussion which follows, this latter definition of "amounts involved" will be used because it most accurately describes Respondents' handling of the Plan's assets.

In order to determine the amount of the penalty, it is necessary to determine how long Respondents used the Plan's assets in each of these instances: "a continuing prohibited transaction, such as a lease or a loan, is treated as giving rise to a separate event subject to the sanction for each year (as measured from the anniversary date of the transaction) in which the transaction occurs." 29 C.F.R. § 2560.502i-1(e)(1). As will be discussed in more detail below, from 1985 when Respondents initially began using Plan assets for their own purposes until 1989 when Respondents repaid the Plan in full, a number of certificates of deposit were issued in the name of "Smith Administrators" and pledged as collateral on various loans. Each of these CDs were purchased using Plan funds.

The basis upon which Complainant's penalty calculations are premised is its determination that, in the majority of the transactions at issue here, the "amounts involved" are the principal amounts rather than interest paid on the principal amounts. This determination affects a dramatic increase in the amount of the penalty Complainant proposes over the alternative: by my calculations, it is the difference between a penalty of $247,000.00 and a penalty of approximately $7,000.00.

In its *Prehearing Statement* and elsewhere, Complainant takes the position that Respondent's transfer of Plan assets and subsequent purchase of numerous CDs with those assets constitutes more egregious conduct than the "mere" transfer or use of plan assets that is contemplated in section 406(a)(1)(D) of the Act. Complainant characterizes Respondent's transfer of the Plan's assets as a "conversion" such that the civil money penalty is properly assessed on the entire principal amounts Respondent transferred. Complainant argues that there was a change in legal title to the Plan's assets when Respondent used them to purchase CDs that were designated as assets of SA and that accordingly, the indicia of ownership were with SA and not the Plan, regardless of Respondent's intentions with respect to the use of the CDs.

Respondents disagree with Complainant's determination that the amount involved in these transactions are the principal amounts that it caused to be transferred out of the Plan, arguing that the language of section 406(a)(1)(D) neither explicitly nor implicitly includes "conversion" as a prohibited transaction. Instead, they contend that the amount involved is the cost of the use of the money for the time periods at issue, or in other words, the interest paid on the CDs while they were outstanding.

According to the Restatement (Second) of Torts, "[c]onversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel." *Restatement (Second) of Torts* § 222A (1965). While the actions that Respondent took with the Plan's assets certainly appear to fit within this definition, the law of the state of Utah would govern Respondent's liability on a tort theory such as conversion. Certainly, ERISA's drafters, or the agencies which promulgated its implementing regulations, could have incorporated Complainant's theory into its language, or into the language of the regulations. It is telling that they did not.

Complainant cites no authority for its conversion theory beyond a repeated reference to 26 C.F.R. 53.4941(e)-1(b)(2)(ii), and I have been unable to locate any support for the theory either. Although in its revenue rulings, private letter rulings, technical advice memoranda and other documents, the Internal Revenue Service has regularly discussed the imposition of the 5% excise tax under section 4941 of the Internal Revenue Code, a provision which parallels section 502(i) of ERISA, little time has been devoted to exploring the complexities of section 53.4941(e)-1(b). Nevertheless, the plain language of that section indicates that where the use of money is at issue, the amount involved in the transaction is the greater of the amounts paid for the use of such money or the FMV for the use of such money for the time periods during which the money was in use. Although Complainant's theory has conceptual merit, it has not persuaded me that the regulations require the result it reaches.

The civil money penalty imposed under section 502(i) is not the only liability that faces plan fiduciaries who engage in prohibited transactions. ERISA provides for substantial criminal and civil liability in such cases, and provides a private right of action for plan beneficiaries against fiduciaries and other parties-in-interest who breach their duties to the plan. Indeed, if Congress had intended the civil money penalty to be a significant deterrent by itself, it would have no doubt provided for the penalty to be a much higher percentage of the amount involved in the transaction.

Large penalties such as the one proposed by Complainant are probably better meted out by Article III courts instead of by administrative tribunals such as this one. Judging by the structure of the criminal and civil penalty provisions in ERISA, Congress evidently did not intend for the administratively-imposed 5% civil money penalty to be the primary disincentive to misconduct by fiduciaries. The theory urged by Complainant would take what is a small weapon in ERISA's overall enforcement arsenal and make it a "big gun."

2. Penalty for Respondents' Use of $246,500.00

Initially, I note that the evidence does not indicate that more than $50,392.78 of the Plan's assets were used to purchase CD No. 328. In its penalty calculations regarding this transaction, Complainant proceeds on the assumption that the entire cost of CD No. 328, namely $246,500.00, was borne by the Plan. As was discussed above, Respondent secured Loan No. 25-20129-4 from Brighton Bank in the amount of $196,107.22. Although CD No. 328 (and its later incarnations) was pledged as collateral for this loan, only $50,392.78 of Plan assets were "at risk" from October 11, 1985 until September 15, 1989 when CD No. 11813-18225 matured and these funds were returned to the Plan account. Accordingly, for purposes of calculating the penalty on this prohibited transaction, the amount involved in the transaction is $50,392.78, *not* $246,500.00.

Respondent's use of the Plan's $50,392.78 in the form of CD No. 328 as collateral for Loan No. 25-20129-4 constitutes both an extension of credit between a plan and a party-in-interest as well as a use by a party in interest of a plan asset; these are both prohibited transactions. ERISA §§ 406(a)(1)(B) & 406(a)(1)(D). As provided by 29 C.F.R. § 2560.502i-1(b), the penalty on this transaction is 5% of the "amount involved" which for present purposes is the FMV of the use of the money for the time periods at issue.

In order to determine the FMV for the Plan's $50,392.78, it is also necessary to define the time period during which the Plan was deprived of the use of these funds. When Respondents executed the promissory note which gave rise to Loan No. 25-20129-4 on October 11, 1985, the Plan initially lost control over the funds. There was a continuing extension of credit and use of the Plan assets until September 15, 1989 when the proceeds of CD No. 346 (formerly No. 328) were rolled into CD No. 11813-17572.

The amount involved in this portion of the transaction is $6,525.08 which yields a penalty of $326.25 (5% × $6,525.08).[16]

3. Respondent's Use of $171,000.00

On February 23, 1987, Respondents executed a promissory note (Loan No. 25-20148-4) in favor of Brighton Bank in the amount of $171,000.00. This note was secured by CD No. 350 purchased on the same day using the Plan's funds. CD No. 350 continued to collateralize Loan No. 25-20148-4 until July 20, 1987 at which time it (along with CD No. 346) was pledged as collateral on Loan No. 1310001. On August 26, 1987, CD No. 350 matured, and Respondents rolled its proceeds, including accrued interest of $2,428.64, over into CD No. 11813-17493 issued in the name of "Smith Administrators"; this CD continued as collateral for Loan No. 1310001. On October 19, 1987, CD

[16]This amount involved is computed as follows:
From 10/11/85 until 10/11/86, the Plan's $50,392.78 earned 7.625% interest as part of CD No. 328; this amounts to earnings of $3,842.45 for this period. From 10/13/86 until 10/13/87, the Plan's $50,392.78 earned 5.125% interest as part of CD No. 346; this amounts to earnings of $2,582.63 for the period. The proceeds of CD No. 328 were rolled into CD No. 346 net of interest.

No. 11813-17493 was rolled over into CD No. 11813-17579 and remained pledged as collateral for the renewed Loan No. 1310001.

CD No. 11813-17493 matured on January 18, 1988. Its proceeds, net of $3,055.79 accrued interest, were combined with the proceeds of CD No. 11813-17572 and CD No. 11813-17578 to purchase CD No. 11813-17735 in the amount of $700,000.00. CD No. 11813-17735 matured on May 17, 1988 at which time it was rolled over, including $15,304.13 accrued interest, into CD No. 11813-17916. This CD served as collateral for Loan No. 1310001 as well as for the $320,000.00 Smith Loan. On September 14, 1988, CD No. 11813-17735 matured and was rolled over net of interest into CD No. 11813-18225; it continued to serve as collateral for both of Respondents' outstanding loans. CD No. 11813-18225 matured on September 15, 1989. Its proceeds of $770,892.12 was deposited into the Plan's account on the same day.

Thus, the Plan was effectively deprived of the use of its $171,000.00 from February 23, 1987 until September 15, 1989. For purposes of calculating the applicable penalty, the amount involved is the FMV of the use of the money over the time period at issue or $30,408.56.[17] Based on this amount, the total penalty for Respondents' use of the Plan's $171,000.00 is $1,520.43 (5% × $30,408.56).

4. Respondent's Use of $300,000.00

On July 20, 1987, Respondents issued a check in the amount of $719,560.56 from the Plan payable to itself. Of these funds, $419,560.56 was used to retire Loan Nos. 25-20148-4 and 25-20129-4. Respondents used the remaining $300,000.00 to purchase CD No. 11813-17420 and pledged it as collateral on a personal loan of $320,000.00 made by TC to Respondent Smith. When CD No. 11813-17420 matured on October 19, 1987, it was rolled over, including $4,861.64 in accrued interest, into CD No. 11813-17578 and continued to collateralize the Smith Loan. At its maturity on January 1, 1988, the principal amount of CD No. 11813-17578 was combined with CD Nos. 11813-17572 and 11813-17578 to purchase CD No. 11813-17735, as discussed above.

Thus, the Plan was deprived of the use of its funds from July 20, 1987 until they were eventually repaid on September 15, 1989. The amount involved in this transaction is the FMV of the use of the money during the time periods at issue or $46,657.91.[18] The applicable penalty on this transaction

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[17]The amount involved in this transaction is calculated in the following manner. From February 23, 1987 until August 26, 1987, the Plan's funds earned 5.625% annual interest. Prorating the annual interest rate for the 185 days at issue yields interest earnings of $4,876.71. Repeating this computation for a 55 day period (August 26 to October 19, 1987) at 6.5% interest yields $1,678.37; for a 92 day period (October 19, 1987 to January 1, 1988) at 7% interest yields $3,016.44; for a 121 day period (January 18, 1988 to May 17, 1988) at 6.65% interest yields $3,763.97; for a 121 day period (May 17, 1988 to September 14, 1988) at 6.75% interest yields $3,820.57; and for a 365 day period (September 14, 1988 to September 15, 1989) at 7.75% interest yields $13,252.50. The total of these amounts is $30,408.56.

[18]The interest earned by the Plan's funds for purposes of this transaction can be calculated in the same manner (continued...)

is \$5,232.80 (5% × \$46,657.91).

5. Respondent's Use of \$100,000.00

On December 9, 1988, Respondents purchased a \$100,000.00 cashier's check payable to Capital City Bank using assets from the Plan's premium transfer account. Ex. C58 & C59; *Respondents' Response to Request for Admissions* No. 133 at 33 & No. 135 at 34. This check was used by Respondents to purchase CD No. 19-006717 in the amount of \$83,000 from Capital City Bank in the name of "Commemorative Publications" on March 14, 1989. Exs. C60 & C61; *Respondents' Response to Request for Admissions* No. 137 at 34. On that same day, Respondent pledged CD No. 19-006717 as collateral for a commercial loan to Commemorative Publications (owned by Respondents) from Capital City Bank. Exs. C60 & C61; *Respondents' Response to Request for Admissions* No. 138 at 34. By October of 1989, the \$100,000 was paid back to the Plan: \$17,335.34 by check from Respondents in March of 1989 [Exs. C64 & C65], and \$85,000 by ALTA Health Strategies, Inc. under the terms of the sale of SA to ALTA.

Purchasing a cashiers check with Plan assets to use for its own account constitutes a "transfer" of Plan assets within the meaning of section 406(a)(1)(D) and is therefore a prohibited transaction. Although both Complainant and Respondents regarded the "amount involved" in this transaction as the entire \$100,000.00 transferred from the Plan by Respondents, I reject this position. As discussed above, for a transfer such as the one involved here, there is little support for Complainant's position that this transaction constitutes a "conversion" such that the amount involved would be the entire amount transferred. Thus, for purposes of calculating the penalty on this transaction, the amount involved will be the FMV of the use of the Plan's assets over the time period at issue.

The Plan was deprived of the use of its assets from December 9, 1988, when Respondents transferred the Plan's assets to their own use, until October 31, 1989, when full repayment was completed, or a total of 328 days.[19]

The record before me does not indicate what interest rate CD No. 19-006717 earned during the period it was outstanding. For purposes of calculating the applicable penalty on this transaction, I

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[18](...continued)
as was that for the \$171,000.00 transaction discussed above and at note 13. Repeating the calculation discussed in note 13 for a 91 day period (July 20 to October 19, 1987) at 6.5% interest yields \$4,861.64; for a 91 day period (October 19, 1987 to January 18, 1988) at 7% interest yields \$5,320.47; for a 120 day period (January 18, 1987 to May 17, 1988) at 6.65% interest yields 6,563.55; for a 120 day period (May 17 to September 14, 1988) at 6.75% interest yields \$6,662.25; and for a 365 day period (September 14, 1988 to September 15, 1989) at 7.75% interest yields \$23,250.00. These amounts total \$46,657.91.

[19]As was indicated briefly above, the Plan was partially repaid on March 27, 1989 when Respondent deposited its \$17,335.34 check into the Plan's account. Thereafter, as part of the sale of SA to ALTA, on October 31, 1989, an additional \$85,000.00 was deposited in the Plan's account, representing CD No. 19-006717 and \$2,000.00 of accrued interest. Thus, full correction of this prohibited transaction within the meaning of 29 C.F.R. § 2560.502i-1(c) was not accomplished until October 31, 1989.

take judicial notice of the applicable federal rate published monthly by the Treasury Department for the time periods at issue.[20] The average of the annual rate for short-term instruments for the period between December 1988 and October 1989 was 8.96%. Using this interest rate, the amount involved in this transaction was $5,318.79 ($7318.79 – $2,000.00 accrued interest paid by ALTA), and the penalty is $265.94.[21]

6. Respondent's Use of $8,252.27

On June 28, 1988, Respondents used Plan assets to refund commissions that were previously paid to Respondents by Quaker State in the amount of $8,252.27. Ex. C66. The transaction was in the nature of a transfer of Plan assets by Respondents to its own accounts in violation of section 406(a)(1)(D), and a 5% penalty is assessed on the transferred amount for each year, or portion thereof, in which the transfer remains uncorrected and outstanding. As with the preceding transaction, the parties are in agreement regarding the amount involved and the resulting penalty. For identical reasons to those I discussed above, I reject their penalty calculations.

The plan was deprived of the use of its assets from June 6, 1988 until October 31, 1989 when the Plan was ultimately repaid by ALTA as a part of its agreement to purchase SA, or 490 days. The average annual short-term interest rate for the period between June 1988 and October 1989 was 8.08%.[22] Using this interest rate, the amount involved in this transaction is $747.46, and the penalty

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[20]Pursuant to 26 U.S.C. § 1274(d), the Secretary of the Treasury issues monthly revenue rulings which set forth the benchmark short, mid, and long term federal interest rates applicable to various federal taxation computations. Given the absence of a precise interest rate for this transaction and the wide availability of the monthly rate notices, I conclude that the applicable federal rate is a reasonable approximation of the interest rate actually paid on CD No. 19-006717. Additionally, the risk factor for the CD at issue here is comparable to that of the government obligations upon which the applicable federal rate is based, *i.e.* minimal, and it is therefore reasonable to expect both instruments to produce similar rates of return.

Section 1274(d)(1)(A) indicates that for debt instruments with a term of not over three years, the federal short term rate is to be used. Accordingly, since CD No. 19-006717 reached maturity within this time frame, I will refer to the applicable short term federal rates for December 1988 until October 1989. Each monthly report indicates the current rate for instruments with annual, semiannual, quarterly, and monthly terms. For the sake of simplicity, and because the Plan's assets were out of its control for almost 90% of a year, I will refer to the annual rates. The following annual rates were applicable during the course of this transaction: December 1988, 8.40%; January 1989, 9.01%; February, 9.30%; March, 9.30%; April, 9.62%; May, 9.82%; June, 9.39%; July, 8.86%; August, 8.34%; September, 8.07%; and October, 8.45%. The average annual rate over this period was 8.96%. This is the rate I will use to assess the penalty.

[21]The amount involved is calculated as follows. From December 9, 1988 to March 27, 1989 (110 days), the Plan's $100,000.00 earned $2,896.96 (8.96% × $100,000.00 × 110/365). From March 28, 1989 until October 31, 1989 (218 days), the Plan's remaining $82, 664.66 earned $4,421.83 (8.96% × $82,664.66 ×218/365). From the total amount involved of $7,318.79, I deducted the $2,000.00 of accrued interest that ALTA repaid the Plan on October 31, 1989 to arrive at the final amount involved of $5,318.79.

[22]The following annual rates were in effect during this transaction: June 1988, 7.57%; July, 7.89%; August. 7.96%; September, not reported; October, 8.56%; December, 8.40%; January 1989, 9.01%; February, 9.30%; March, (continued...)

is $37.37.[23]

7. Respondent's Use of $5,716.38

Respondents acknowledged that they paid certain bank charges in the amount of $5,716.38 with Plan assets. *Respondents' DOL Penalties-Transaction Analysis*, attached as Exhibit A to its responses to DOL's first set of requests for admissions at p.3. The transaction was in the nature of a transfer of Plan assets by Respondents to its own accounts in violation of section 406(a)(1)(D), and a 5% penalty is assessed on the transferred amount for each year, or portion thereof in which the transfer remains uncorrected and outstanding. It is unclear exactly how long Plan assets were outstanding as a part of this transaction. Complainant assessed a penalty for 1989 only, and, for lack of more complete information, I will accept this time frame. The average short-term interest rate applicable during the period from January 1, 1989 until December 31, 1989 was 9.58%.[24] Using this rate, the amount involved in this transaction was $547.63, and the penalty is $27.38.[25]

8. Total Penalty

Based on the foregoing discussion and calculations, the total amount of the penalty that will be imposed on Respondents under section 502(i) of the Act is $7,083.92.

D. Liability of Respondent SA and Richard L. Smith

Section 502(i) of the Act provides, in pertinent part, "[i]n the case of a transaction prohibited by section 1106 of this title by a party in interest with respect to a plan to which this part applies, the Secretary may assess a civil penalty against such party in interest." 29 U.S.C. § 1132(i). The regulations at 29 C.F.R. §2560.502i-1 mirror this language. Since I have determined that both Respondents acted as fiduciaries to the Plan with respect to the various transactions at issue here, both are also "parties-in-interest" within the meaning of section 502(i). *See* 29 U.S.C. § 1002(14). Additionally, even if I did not initially regard Respondent Smith as a plan fiduciary and party-in-interest, his ownership of 100% of the outstanding stock in SA (which is a plan fiduciary or, at least, a "person providing services to the plan" under section 3(14)(B)) would still cause him to fall within the statutory definition of party-in-interest. 29 U.S.C. §1002(14)(H) (an employee, officer, director, or 10% or more shareholder in a party-in-interest is also a party-in-interest). Accordingly, both

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[22](...continued)
9.30%; April, 9.62%; May, 9.82%; June, 9.39%; July, 8.86%; August, 8.34%; September, 8.07%; and October, 8.45%. The average of these rates is 8.08%.

[23]The amount involved in this transaction is calculated as follows: 8.08% × $8,252.27 × (490/365).

[24]The following annual rates were in effect during this transaction: January 1989, 9.01%; February, 9.30%; March, 9.30%; April, 9.62%; May, 9.82%; June, 9.39%; July, 8.86%; August, 8.34%; September, 8.07%; October, 8.45%; November, 8.39%; and December 8.02%. The average of these rates is 9.58%.

[25]The amount involved in this transaction is calculated as follows: 9.58% × $5,716.38 × (365/365).

Respondents are jointly liable for the civil penalty imposed herein under section 502(i) of the Act and 29 C.F.R. § 2560.502i-1.

ORDER

It is hereby ORDERED that Respondents Smith Administrators and Richard L. Smith are jointly and severally liable to the U.S. Department of Labor for civil money penalties in the amount of $7,083.92 pursuant to 29 C.F.R. § 2560.502i-1 for violations of section 502(i) Employee Retirement Income Security Act of 1974. Respondents are directed to pay the above stated penalties within thirty (30) days from the date of service of this decision. Amounts not paid by that time shall be subject to penalties and interest provided for by the Act and applicable regulations.

Entered on this date, January, ___, 1998, by:

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JAMES GUILL
Associate Chief Judge

at Washington, D.C.

NOTICE OF APPEAL RIGHTS

Pursuant to 29 C.F.R. Section 2570.69 a notice of appeal must be filed with the Secretary of Labor within twenty (20) days of the date of service of this decision or the decision of this decision shall become the final agency action within the meaning of 5 U.S.C Section 704.